FDIC

Federal Deposit Insurance Corporation

Washington, D.C. 20434 Office of Inspector General

DATE: March 28, 1997

MEMORANDUM TO: Steven Metildi
Chief, Acquisition Services Branch
Western Service Center

recommendations and provided the requisite elements of a management decision for both recommendations. WSC management's response is included in this report as Appendix IV. Appendix V presents our assessment of management's responses to the recommendations and shows that we have a management decision for both recommendations. As a result of this evaluation, the OIG will report questioned costs of $996,128 in its *Semiannual Report to the Congress*.

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Introduction

This report presents the results of our review of FDIC's contract with STF to provide telephone service and equipment to the WSC. On July 15, 1996, the Associate Director, ASB, expressed concerns that STF had over billed or erroneously billed FDIC for telephone services and equipment and asked our office to review the contract billings. Accordingly, our objective was to determine the propriety of contractor charges for services and equipment and the amount of questioned costs. This report provides WSC with the results of our review of charges under the contract.

STF and FDIC have fundamentally different interpretations on several key contract terms and provisions. Both parties agree that overcharges have occurred, but disagree on the extent of overcharges. FDIC extended STF's contract through the end of 1997 and STF continues to provide telephone service and equipment to FDIC's Irvine, California office. As an interim measure, in October 1996, STF and FDIC entered into a memorandum of understanding to allow for partial payment of invoices until contract differences are resolved. The findings in this report are based on our understanding of both STF's and FDIC's contract interpretations. To the extent possible, we have recalculated contract charges using those interpretations.

We performed the following work to determine the propriety of STF's charges.

- Interviewed headquarters ASB, Legal, DRR, Division of Research and Statistics, and DIRM officials. Obtained and reviewed relevant supporting documentation from headquarters officials.

- Interviewed WSC ASB, Legal, DRR, and DIRM officials.

- Interviewed FDIC's outside counsel, who was hired to assist WSC in resolving this matter.

- Reviewed pertinent contract and program file documents.

- Interviewed STF officials from STF's Los Angeles, California office and from its headquarters office in Chantilly, Virginia.

- Obtained and reviewed available STF invoices for the period of July 1991 through March 1996.

- Obtained and reviewed electronic billing files showing all charges for the period from July 1991 through March 1996. Analyzed the records using data extraction and analysis software, called Interactive Data Extraction and Analysis (IDEA) for Auditors.

- Analyzed 100 percent of Interstate, Interlata, and Intralata calls (almost 2 million calls).[1]

- Analyzed three types of equipment items--DTerm 2 Series II, DTerm 6 Series II, and DTerm 6 Series II with Speaker. In comparison to other equipment, STF significantly increased the prices it was charging for this equipment over the life of the contract.

- Subpoenaed and analyzed PacBell billings for the period from July 1991 through March 1996 to determine the propriety of STF charges for trunk lines and other pass through charges.

- Analyzed a limited number of work orders to review charges for moves, adds and changes. We could not perform a detailed review of this area because FDIC did not retain work orders for periods prior to February 1995.

- Issued interim letters and memoranda to both FDIC and STF explaining our understanding of their interpretations, requesting clarification of those interpretations, and providing preliminary results of our analysis of charges.

We conducted this review from July 1996 to January 1997 in accordance with the President's Council on Integrity and Efficiency's *Quality Standards for Inspections*. A detailed discussion of our methodology for reviewing contract charges is included as Appendix III.

[1]The terms Interstate, Interlata, and Intralata refer to geographic areas of telephone service. These terms are defined in the Background section of this report.

Results in Brief

STF has overcharged FDIC for telephone service and equipment under the contract. However, STF and FDIC have fundamentally different interpretations on several key issues under the contract, and thus, disagree on the extent of overcharges. During the period July 1991 through March 1996, STF charged FDIC about $3.7 million for telephone service and equipment. Using STF contract interpretations, we determined STF overcharged FDIC by $461,358 to $494,402 during that period. Using FDIC contract interpretations, we determined STF overcharged FDIC by $823,208 to $996,128.

The extent of overcharges differs depending on the various scenarios and assumptions used. Key contract issues in dispute include: what geographic areas are considered long distance, whether call duration should have been rounded to the next highest minute for billing purposes, how STF should have adjusted its rates in response to rate decreases from FDIC's national long distance carrier, whether STF was allowed to mark up local exchange carrier charges before passing them on to FDIC, and to what extent STF was allowed to escalate equipment charges. These interpretations and scenarios are discussed in detail in this report and accompanying appendixes.

Background

FDIC awarded the subject contract on April 11, 1991. STF began providing telephone service and equipment in mid-June 1991. Under the contract, STF provided telephone service and leased telephone equipment to FDIC's WSC located at the 4 Park Plaza building in Irvine, California. The contract was approved as part of a global case authorizing the lease of the 4 Park Plaza building.

In April 1992, FDIC awarded a national long distance contract to MCI Telecommunications Corporation (MCI). MCI is the long distance carrier for all FDIC offices except for the Irvine and Franklin offices. In most FDIC offices, MCI provided long distance service and the local exchange carrier (LEC) provided local service. The field offices received separate invoices for long distance and local service. In Irvine, STF provided long distance service and had a separate contract with the LEC, PacBell, for local service. PacBell billed STF for local service and STF in turn billed FDIC.

With respect to telephone equipment, most FDIC offices owned rather than leased the equipment. According to the Chief, Voice and Video Network Services Unit (VVNSU), FDIC awarded the STF contract at a time when the futures of FDIC field offices were uncertain, and it made more sense to lease equipment rather than risk buying equipment for a potentially closing office. Accordingly, FDIC leased all WSC telephone units, voice mail, and other necessary equipment from STF.

History of the Telecommunications Industry Regulation As It Applies to the Subject Contract

The telecommunications industry is governed by the Federal Communications Act and the Federal Communications Commission rules and policies with respect to interstate and international services and by the California Public Utilities Code and California Public Utilities Commission (CPUC) rules and policies for intrastate services.

In 1982, the U.S. Department of Justice (DOJ) and AT&T agreed to a Modification of Final Judgment (MFJ) as part of the DOJ's antitrust suit against AT&T. Effective January 1, 1984, the MFJ required AT&T to divest its local telephone operations into independent Bell operating companies (BOCs) held by seven regional holding companies. Pacific Telesis Group is the regional holding company for California and Nevada. PacBell is the BOC for California.

In the process of implementing the divestiture, the U.S. District Court approved a plan which divided each BOCs' service areas into 161 Local Access and Transport Areas (LATAs). The BOCs were authorized to continue to provide service within each of their respective LATAs, but were prohibited from offering service between LATAs. California was divided into ten

LATAs, the largest of which, LATA 5, comprises most of Southern California, including Los Angeles and Irvine.

Divestiture allowed competing long distance carriers, such as AT&T, MCI, U.S. Sprint and STF, to provide long distance service between LATAs. However, in California, long distance carriers were not allowed to compete for service within the LATA. Only the BOCs were authorized to provide local and LATA service. The CPUC did allow long distance carriers to complete LATA calls if a customer consciously programmed its equipment to specifically direct calls to the long distance carrier.

Effective January 1, 1995, the CPUC authorized long distance carriers, such as STF, to offer LATA service. STF sought and received authorization to provide LATA service. Effective January 1 and March 1, 1996, the CPUC authorized a number of carriers to provide competing local exchange services. However, FDIC found no evidence that STF had applied for authorization to provide local service.

Geographic Calling Areas

Telephone service is billed based on where a call originates and terminates. The point of termination determines the charge. Calling areas are divided into a number of geographic bands for billing and regulation purposes. Table 1 presents a description of each geographic calling area, with the point of origin being the WSC's Irvine office.

Table 1: Definitions of Geographic Calling Areas

Geographic Area	Description
Local Calling Area (Local)	Calls terminating within zero to 12 miles of Irvine, CA. These calls are also known as Zone 1 and 2 calls. Over the term of the contract, PacBell handled Local calls exclusively. Local charges are based on PacBell tariff rates approved by the CPUC. Since 1989, PacBell rates changed only once, in January 1995. Local calls include calls to Santa Ana, Laguna Beach, and Newport Beach.
Zone Usage Measurement (ZUM)	Calls terminating within 12 to 16 miles of Irvine. This area is also known as Zone 3. These calls were handled by PacBell and subject to PacBell tariff rates. ZUM calls are billed at a slightly higher rate than local calls. ZUM calls include calls to Capistrano Valley, Fullerton, and Huntington Beach.
Intrastate/Intralata (Intralata)	Calls terminating outside of the ZUM, but within LATA 5. These calls are also known as Toll Calls. PacBell Intralata rates were based on mileage bands. STF filed Intralata rates with CPUC, effective January 1995, which are also based on mileage bands and which are slightly higher than PacBell rates. Intralata calls include calls to Orange, Los Angeles, Ventura, Inyo, and Mono Counties and western portions of San Bernadino and Riverside Counties.
Intrastate/Interlata (Interlata)	Calls which terminate outside of LATA 5, but within California. These calls cross LATA lines. Includes calls to San Francisco, Sacramento, and San Diego.
Interstate (Interstate)	Calls which terminate outside of California in any State, Territory, or possession of the United States, or the District of Columbia. This area includes calls to Houston, TX, and Washington, DC.
International (International)	Non-domestic calls terminating outside of the 50 states. Includes calls to Canada and Europe.

Source: File reviews and interviews with STF and FDIC officials.

We used the geographic calling areas presented in Table 1 to develop STF's and FDIC's contract interpretations and to analyze contract charges. Both parties' respective positions and the results of our analysis are addressed in later sections of this report.

Contract Charges Under the Agreement

During the period July 1991 through March 1996, STF charged FDIC about $3.7 million for telephone service and equipment. Telecommunication charges may be divided into two categories, usage based rates and non-usage based rates. Usage rates are the charges for telephone service and include charges for interstate, interlata, intralata, and local calls. Non-usage rates include fixed recurring and non-recurring charges such as charges for trunk

Figure 1: Composition of STF Charges

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STF and FDIC Respective Contract Interpretations

As discussed earlier, STF and FDIC have fundamentally different interpretations on several key contract terms and provisions. Both STF and FDIC agree that the original contract was vague and poorly written. The contract consisted of a one page Service Order Agreement containing a schedule of equipment charges, one page describing contract terms and conditions, and an Addendum to the Service Order Agreement amending contract terms. The Addendum contains typographical errors and is missing key words. A brief discussion of the issues in question follows. A detailed discussion of each issue is included at Appendix I.

Issue: What is the definition of long distance?

Provision 14 of the Addendum to the Service Order Agreement states:

> "Fairchild agrees to provide long distance service to Customer at a rate of fifteen cents ($.15) per minute."

STF's Interpretation:

STF considers the following geographic bands long distance and subject to the $.15 per minute postalized rate.

- Interstate -- excluding Alaska and Hawaii
- Intrastate/Interlata

FDIC's Interpretation:

FDIC considers the following geographic bands long distance and subject to the $.15 per minute postalized rate.

- International
- Interstate -- including Alaska and Hawaii
- Intrastate/Interlata
- Intrastate/Intralata greater than 16 miles from origin.

Issue: How should call duration be rounded for billing purposes?

The contract is silent regarding whether individual call duration should be rounded to the (1) next highest whole minute, or (2) next highest tenth of a minute for billing purposes.

STF's Interpretation:

STF's position is that it properly rounded call durations to the next highest whole minute. For example, a call lasting 2 minutes, 34 seconds would be rounded to 3 minutes for billing purposes.

FDIC's Interpretation:

FDIC believes STF should have rounded calls to the next highest tenth of a minute. For example, the same call lasting 2 minutes, 34 seconds would be rounded to 2 minutes, 36 seconds, or 2.6 seconds for billing purposes.

Issue:* *How should STF have adjusted its rates in response to rate changes made by competitors?

Provision 14 of the Addendum to the Service Order Agreement states:

> "Should Customer negotiate a new rate with a major long distance carrier (i.e., AT&T, MCI or US Sprint) on a national account basis, Fairchild agrees to adjust this rate an equal percentage."

FDIC signed a national contract with MCI in April 1992. FDIC notified STF of the rates under the MCI contract in June 1995. In September 1995, STF offered FDIC a rate of $.09 per minute for interstate, $.11 per minute for interlata, and a one time $50,000 credit as settlement for prior overcharges. FDIC considered the offer insufficient and never responded to STF.

STF's Interpretation:

STF acknowledges that FDIC requested a rate change in June 1995. However, STF contends that STF's and MCI's rate structures were incompatible and FDIC never communicated how STF should lower its rates to match the MCI rate. STF's September 1995 letter was a settlement offer unrelated to Provision 14 of the Contract. Because FDIC never responded, STF never implemented the $.09/.11 per minute rate.

FDIC's Interpretation:

FDIC's position is that its June 1995 notification was sufficient and that STF should have reduced its rates at that time. FDIC initially acknowledged that it did not know what the appropriate rate should be, but concluded that STF should have matched actual MCI rates, or, at a minimum, should have implemented the $.09/$.11 per minute rates retroactive to June 1995. FDIC later clarified its position and stated that STF should have lowered its rates by an equal percentage to match MCI rate reductions. Accordingly, FDIC's clarified position is presented in this report. The calculation of these percentage rates is addressed in detail in Appendix I.

Issue: How should flow through charges from PacBell have been handled?

PacBell, the LEC, bills STF for local calls, directory assistance, trunk line charges, and other charges for service at 4 Park Plaza. STF, in turn, bills FDIC, but adds a mark up to cover administrative costs.

STF's Interpretation:

CPUC guidelines allow STF to charge a reasonable mark up to recover its billing, facilities and management services costs in providing local exchange service. Accordingly, STF based charges for local and intralata service, trunk lines, and other services on either PacBell tariff rates or STF tariff rates as approved by the CPUC. STF did not charge FDIC according to the lower rates that STF had negotiated with PacBell.

FDIC's Interpretation:

CPUC guidelines require STF to directly rebill to tenants on a flow-through or pro rata basis all charges for service from the local telephone utility. Accordingly, STF should have passed-through to FDIC, without mark up, actual PacBell charges to STF for local and intralata service, trunk lines, and other services.

Issue: To what extent should equipment charges have been escalated?

STF also leased telecommunications equipment to FDIC. The first page of the Service Order Agreement presented a schedule of charges for each equipment type and the number of equipment items ordered. Section 4, “Price and Payments” of the Terms and Conditions page of the contract, as amended by the Addendum to the Service Order Agreement states:

> “Customer agrees to pay for the Services at the rates specified on the first page of this Agreement or in Fairchild’s standard rate card, as appropriate. Customer’s non-usage based rates may be subject to an annual increase not to exceed the lesser of five percent (5%) of [sic] the Bureau of Labor Standards and Statistics CPI for Urban Wage Owners of Southern California. [sic] upon thirty (30) days written notice by Fairchild.”

STF’s Interpretation:

STF contends that the Service Order equipment prices pertained only to the initial complement of equipment. STF believes the contract implies that additional equipment would be billed at higher rates. Further, STF claims the contract is consistent with industry practices. STF reported that additional equipment was billed at the rates specified in STF’s standard rate cards. These rates were documented in work orders submitted to FDIC.

FDIC’s Interpretation:

FDIC contends that equipment prices for the term of the contract were set forth on the first page of the Service Order Agreement. The contract allowed for annual escalation of equipment charges by the lesser of Consumer Price Index or 5 percent. FDIC believes that any price increases whether delivered in the form of work orders or standard rate card should have conformed with the annual escalation limits listed in Section 4.

Analysis of Contract Charges

STF has overcharged FDIC for telephone service and equipment under the contract. However, because STF and FDIC have different interpretations on key contract issues, the parties disagree on the extent of overcharges. During the period July 1991 through March 1996, STF charged FDIC over $3.7 million for telephone service and equipment. Using STF and FDIC contract interpretations, we determined STF overcharged FDIC by $461,358 to $996,128 during that period. The extent of overcharges differs depending on the various scenarios and assumptions used.

This section presents an analysis of contractor charges using both STF and FDIC assumptions discussed in the preceding section and a number of scenarios. Table 2 briefly defines each scenario used to analyze contract charges. A detailed explanation of each scenario is included as Appendix II.

Table 2: Scenarios Used to Analyze Contract Charges

Whole Minute Rounding		Tenth of a Minute Rounding	
Scenario 1:	No change in long distance rates over the term of the contract.	Scenario 4:	No change in long distance rates over the term of the contract.
Scenario 2:	STF's September 1995 settlement offer implemented retroactive to June 1995.	Scenario 5:	STF's September 1995 settlement offer implemented retroactive to June 1995.
Scenario 3:	STF matched MCI rate changes by an equal percentage retroactive to June 1995.	Scenario 6:	STF matched MCI rate changes by an equal percentage retroactive to June 1995.

Interstate Calls

Both STF and FDIC agree that interstate calls are long distance calls that should have been subject to the $.15 per minute rate. On average, STF charged about $.15 per minute for interstate calls over the term of the contract. During some months, STF charged less than $.15 per minute. Under the first scenario, we estimate that STF underbilled for interstate calls by $6,006. Otherwise, we estimate that STF overbilled by $19,155 to $52,036 depending upon the scenario used. Table 3 presents the overbilling (underbilling) identified in our analysis of interstate calls.

Table 3: Analysis of Interstate Call Charges

CHARGE TYPE	Whole Minute Scenario			Tenth of a Minute Scenario		
	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
STF Charge	$336,337	$336,337	$336,337	$336,337	$336,337	$336,337
FDIC Interpretation	$342,343	$317,182	$308,200	$315,299	$292,453	$284,301
Difference	($6,006)	$19,155	$28,137	$21,038	$43,884	$52,036

Source: STF invoices and electronic files

Interlata Calls

Both STF and FDIC agree that interlata calls are long distance calls that should have been subject to the $.15 per minute rate. On average, STF charged about $.295 per minute for interlata calls over the term of the contract. We identified calls to the San Francisco area that were billed at $.44 per minute. Depending on the scenario used, we estimate that STF overbilled for interlata calls by $236,050 to $271,316. Table 4 presents the overbilling identified in our analysis of interlata calls.

Table 4: Analysis of Interlata Call Charges

CHARGE TYPE	Whole Minute Scenario			Tenth of a Minute Scenario		
	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
STF Charge	$477,350	$477,350	$477,350	$477,350	$477,350	$477,350
FDIC Interpretation	$241,300	$233,417	$225,284	$220,562	$213,412	$206,034
Difference	$236,050	$243,933	$252,066	$256,788	$263,938	$271,316

Source: STF invoices and electronic files.

Intralata Calls

FDIC and STF disagree on how intralata calls should have been billed. FDIC considers intralata calls to be long distance subject to the $.15 per minute postalized rate. STF does not consider intralata calls to be long distance. STF believes these calls should have been billed at existing PacBell and STF tariff rates in effect at various times over the contract. On average, STF charged about $.175 per minute for intralata calls over the term of the contract. While we did not perform an exhaustive review, nothing came to our attention to suggest that STF charged rates for intralata calls higher than established PacBell and STF tariff rates. For example, we identified a call to Long Beach that was billed at $.20 per minute. We also identified a call to the Los Angeles area that was billed at $.32 per minute. Both of these rates were less than PacBell tariff rates in effect at that time. Accordingly, STF believes it has billed FDIC accurately for intralata calls.

Using FDIC's interpretations, depending on the scenario used, we estimate that STF overbilled for intralata calls by $121,007 to $200,619. Table 5 presents the overbilling identified in our analysis of intralata calls using FDIC's interpretations.

Table 5: Analysis of Intralata Call Charges

CHARGE TYPE	Whole Minute Scenario			Tenth of a Minute Scenario		
	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
STF Charge	$759,613	$759,613	$759,613	$759,613	$759,613	$759,613
FDIC Interpretation	$638,606	$619,555	$599,952	$593,780	$576,636	$558,994
Difference	$121,007	$140,058	$159,661	$165,833	$182,977	$200,619

Source: STF invoices and electronic files.

Trunk Lines & Other Charges

STF and FDIC also disagree on how charges for trunk lines and other PacBell products and services should have been billed under the agreement. STF contracted directly with PacBell to provide service to 4 Park Plaza. STF then passed PacBell bills through to FDIC. PacBell charged STF for access to trunk lines for making calls beyond the local exchange area. PacBell also charged STF for other products and services. STF believed that CPUC guidelines permitted STF to mark up PacBell charges to recover its administrative costs. However, STF acknowledged that at some point during the contract, PacBell reduced the number of trunk lines at 4 Park Plaza, and STF did not correspondingly reduce FDIC's trunk line charges.

FDIC believes STF should have passed through PacBell charges to FDIC without mark up. Using FDIC's interpretation, we identified $231,251 in STF charges for trunk lines, local service, local directory assistance and other charges that were not supported by PacBell billings. STF has agreed to accept our results for the time being, but reserved the right to review our workpapers at a later date. Table 6 presents our analysis of trunk lines and other pass through charges.

Table 6: Analysis of Trunk Lines and Other Pass Through Charges

Type of Charge	PacBell Billings	STF Invoice or Electronic File	Unsupported Costs
Trunk Lines (includes Access for Interstate Dialing charges)	$105,803	$283,562	$177,759
Direct Inward Dialing	46,258	60,084	13,826
Local Calls (Zone 1, 2 & 3)	52,115	85,835	33,720
Local Directory Assistance	15,875	21,821	5,946
Total Costs	$220,051	$451,302	$231,251

Source: PacBell Bills for 4 Park Plaza Building, STF invoices to FDIC and STF electronic files.

Equipment Charges

STF and FDIC also disagree over how equipment should have been billed under the contract. STF's interpretation is that the equipment prices listed in the contract applied only to the initial complement of equipment. STF billed additional equipment installations according to prices listed in STF standard rate cards or work orders. Accordingly, STF escalated equipment prices over the life of the contract. STF reported that it did overcharge FDIC by $63 associated with the initial equipment installation.

FDIC's interpretation is that equipment should have been priced according to amounts listed on the first page of the contract. The contract allowed STF to escalate these prices by no more than five percent annually. We analyzed three types of equipment under the contract. Using FDIC's interpretations, we identified $240,906 in overcharges. Table 7 presents an analysis of the three types of equipment reviewed.

Table 7: Analysis of Equipment Charges

Equipment Type	STF Invoice or Electronic File	Charge Based on FDIC Interpretation	Difference
DTerm 2 Series II	$93,467	$17,697	$75,770
DTerm 6 Series II	245,172	96,109	149,063
DTerm 6 Series II w/ Speaker	53,035	36,962	16,073
Totals	$391,674	$150,768	$240,906

Source: STF invoices to FDIC and STF electronic files.

Regardless of the interpretation used, we question whether STF price increases were reasonable. As discussed in Appendix I of this report, STF billed DTerm 6 telephone units added after the initial month of the contract at a 2,400 percent increase over the initial contract rate. Presented another way, FDIC has paid monthly recurring charges of more than

$1,800 per unit for DTerm 6 telephones installed in mid to late 1991. Over this 5-year period, these telephones should be completely depreciated. Further, according to FDIC's Chief, VVNSU, given the rapid development of the telecommunications industry, these telephones may be technically obsolete.

Summary and Recommendations

As discussed earlier, STF believes that calls should have been billed on a whole minute basis, interstate and interlata calls should have been subject to the $.15 minute rate, CPUC guidelines permitted the mark up of PacBell charges passed-through to FDIC, and the contract allowed escalation of equipment charges. Using STF interpretations, we estimate that STF overcharged FDIC by $461,358 to $494,402. Table 8 presents a summary of overcharges using STF interpretations.

Table 8: Overcharges Using STF Interpretations

CHARGE TYPE	Whole Minute Scenario	
	Scenario 1	Scenario 2
Interstate Calls	$(6,006)	$19,155
Interlata Calls	236,050	243,933
Intralata Calls	0	0
Trunk Lines and Other Charges	$231,251	$231,251
Equipment Charges	63	63
Total Differences/ Overcharges	**$461,358**	**$494,402**

Source: STF Invoices, STF electronic billing files, and PacBell billings.

FDIC believes that interstate, interlata, and intralata calls should have been subject to the $.15 minute rate, calls should have been billed on a tenth of a minute basis, CPUC guidelines prohibited STF from marking up PacBell charges passed-through to FDIC, and the contract only allowed for minimal escalation of equipment charges. Using FDIC interpretations, we estimate that STF overcharged FDIC by $823,208 to $996,128. Table 9 presents a summary of overcharges using FDIC interpretations.

Table 9: Overcharges Using FDIC Interpretations

CHARGE TYPE	Whole Minute Scenario			Tenth of a Minute Scenario		
	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
Interstate Calls	($6,006)	$19,155	$28,137	$21,038	$43,884	$52,036
Interlata Calls	236,050	243,933	252,066	256,788	263,938	271,316
Intralata Calls	121,007	140,058	159,661	165,833	182,977	200,619
Trunk Lines and Other Charges	$231,251	$231,251	$231,251	$231,251	$231,251	$231,251
Equipment Charges	240,906	240,906	240,906	240,906	240,906	240,906
Total Differences/ Overcharge	**$823,208**	**$875,303**	**$912,021**	**$915,816**	**$962,956**	**$996,128**

Source: STF Invoices, STF electronic billing files, and PacBell billings.

The findings in this report are based on our understanding of both STF's and FDIC's contract interpretations. To the extent possible, we recalculated contract charges using those interpretations.

Based on a strict reading of the contract, we are questioning $996,128 in STF charges to FDIC. Accordingly, we recommend that the Chief, ASB, WSC take the following actions.

(1) Enter into settlement negotiations with STF and attempt to recover amounts charged that were not supported by the contract or industry practice, or that appear unreasonable.

(2) Modify the existing contract to reflect agreements reached during the settlement negotiations on the intent of contract terms that are currently vague or poorly written.

Corporation Comments and OIG Evaluation

On March 24, 1997, Western Service Center (WSC) management provided a written response to a draft of this report. The response is presented as Appendix IV to this report. WSC management disallowed the full amount of our questioned costs and provided the requisites for a management decision for both of the recommendations. A summary of the response and our analysis follows.

In its response, FDIC requested that we delete certain statements and statistics from the final report which provided insight and opinions regarding FDIC's position and strategy on issues in dispute. We held a conference call with Irvine management on March 25, 1997, to address FDIC's request. To the extent that the text did not weaken the support for our statements and conclusions or compromise our objectivity, we complied with FDIC's request. FDIC also clarified its position regarding STF's requirement to match MCI rates by an equal percentage change. We recalculated overcharges using FDIC's clarified position and adjusted our questioned costs by $13,569 from $982,559 to $996,128. Accordingly, the actual questioned cost amount in this report differs from the questioned amount discussed in FDIC's March 18, 1997, response. However, the Corporation has agreed to disallow the $996,128 figure.

Disallow $996,128 in STF charges to FDIC. Enter into settlement negotiations with STF and attempt to recover amounts charged that were not supported by the contract or industry practice, or that appear unreasonable (questioned costs, all of which is unsupported): WSC management agreed with our recommendation. The Corporation will seek to recover the full amount of the $996,128 in questioned costs as well as additional contract overcharges occurring from April 1996 to the present and charges for FDIC outside counsel retained to assist in the resolution of this matter. The response noted that FDIC has already withheld payment of $175,000 from STF billings under a partial payment memorandum of understanding.

WSC management's response estimated that settlement discussions should be completed within 3 months of the date of this report and that the executed settlement agreement and receipt of funds by FDIC from STF would document completion of this action. WSC management's response adequately addressed the recommendation and contained all the requisites of a management decision.

Modify the existing contract to reflect agreements reached during the settlement negotiations on the intent of contract terms that are currently vague or poorly written: WSC management agreed with our recommendation. The Corporation will enter into an amended and restated agreement with STF to clarify all vague or poorly written contract terms and which will also conform to FDIC's *Acquisition Policy Manual*. Further, DIRM will prepare a statement of work which will be part of the new agreement.

WSC management's response indicated that the new agreement should be in place within 3 months of the date of this report and the executed agreement will document completion of this action. WSC management's response adequately addressed the recommendation and contained all the requisites of a management decision.

As a result of this evaluation, the OIG will report questioned costs of $996,128 in its *Semiannual Report to the Congress*. Appendix V presents WSC's proposed actions on the recommendations and shows that we have management decisions for both recommendations in this report.

Appendix I: Discussion of Respective Positions

STF and FDIC have fundamentally different interpretations on several key contract terms and provisions. Both STF and FDIC agree that the original contract was vague and poorly written. The contract consisted of a one page Service Order Agreement containing a schedule of equipment charges, a one page Terms and Conditions section and an Addendum to the Service Order Agreement amending contract terms. The Addendum contains typographical errors and is missing key words.

Telecommunication charges may be divided into two categories, usage based rates and non-usage based rates. Usage rates are the charges for the use of telephone service and include charges for interstate, interlata, intralata, and local calls. Non-Usage rates include other charges such as charges for trunk lines, DID, and equipment charges.

Usage Rate Charges

Usage rates are those charges for making telephone calls. Key usage rate contract issues in question include: (1) what geographic areas are considered long distance, (2) whether call duration should have been rounded to the next highest minute for billing purposes, (3) how STF should have adjusted its rates in response to rate decreases from FDIC's national long distance carrier, and (4) whether STF was allowed to mark up local exchange carrier charges before passing them on to FDIC.

A primary weakness in the contract is the absence of a definition section for long distance. The contract requires STF to provide long distance service to FDIC at a postalized rate of $.15 per minute. However, the contract does not define "long distance" or address whether the per minute rate applies to international calls, calls to Alaska or Hawaii, or calls within and around the Irvine area code. Provision 14 of the Addendum to the Service Order Agreement states:

> "Fairchild agrees to provide long distance service to Customer at a rate of fifteen cents ($.15) per minute. Should Customer negotiate a new rate with a major long distance carrier (i.e., AT&T, MCI or US Sprint) on a national account basis, Fairchild agrees to adjust this rate an equal percentage."

In an August 6, 1996, letter to FDIC, STF's Vice President and General Counsel, reported that STF interprets long distance service to include only interstate and interlata calls. STF considers that all calls terminating outside of LATA 5, but within the continental United States long distance subject to the $.15 per minute rate. Accordingly, STF does not consider calls to Los Angeles--approximately 40 miles away--to be long distance. Further, STF does not consider calls to Alaska, Hawaii, or international calls as long distance, subject to the $.15 per minute rate.

FDIC also considers interstate and interlata service long distance. However, FDIC considers international calls, calls to Alaska and Hawaii, and intralata calls terminating in excess of 16 miles of Irvine to be long distance calls subject to the $.15 per minute rate. FDIC's support for considering intralata calls as long distance lies within CPUC Decision 84-06-111, adopted in June 1984. This decision implemented the first host divestiture rate design changes for PacBell and AT&T's California operations. In discussing PacBell's rate design for Toll and Toll-Related Services, also known as intralata service, the decision states:

> "Message toll rates for <u>long distance service</u> within PacBell's serving areas are increased slightly for calls up to 50 miles, but elimination of the current 10.32% surcharge means a decrease in toll charges overall." (Emphasis added)

Further, FDIC believes that normal usage defines long distance service as including international, interstate, interlata, and intralata toll calling. FDIC concluded that the argument of whether the $.15 per minute rate applied to intralata calls was probably moot because STF did provide intralata toll service to FDIC and there was no other basis under the contract for determining what the proper price would have been. FDIC further noted that Paragraph 10 of the Addendum committed STF to provide billing detail for local exchange service and long distance service. Similarly, the Agreement itself included, as Paragraphs 3 and 4, categories for Local Exchange Service and Long Distance Service. FDIC concluded that these provisions suggested a common understanding of the parties that long distance service included all calls that were not local calls.

We found conflicting definitions of which geographic areas long distance includes. For example, a Local Irvine telephone directory defined LATAs as boundaries for determining which companies handle short and long distance toll calling. The telephone directory defined Short Distance as calls to points within LATA 5 and Long Distance as calls to points outside of LATA 5. However, Standard & Poor's, September 12, 1996, Telecommunications Wireline: Industry Survey, discussed the heated competition between LECs and long distance telephone companies for the $13 billion intra-LATA toll market that "...represents long-distance calls that both originate and terminate within one LATA."

Moreover, in describing competition following the 1984 divestiture of AT&T, the Industry Survey noted that Regional Holding Companies such as Pacific Telesis "...were allowed to provide long-distance services within each LATA." Also, in describing the current regulatory environment, the Industry Survey stated: "Within their core market, some companies [LECs] may also provide intrastate toll service, a kind of long-distance service often referred to as intra-LATA service."

However, even the Industry Survey is inconsistent. A June 8, 1995, Standard & Poor's Telecommunications Industry Survey presented a table showing various telecom markets that presented the "Intra-LATA toll" market as a "Local telephone" market.

As discussed later, we did not attempt to identify and separate international calls or calls to Alaska and Hawaii, because of the small number of calls and immateriality of charges. With respect to intralata calls, had STF used FDIC's interpretation and billed intralata calls at $.15 per minute, FDIC would have realized a savings of $121,007 to $200,619 depending on the scenario used.

Rounding of Call Duration

FDIC and STF also dispute whether call durations should have been rounded for billing purposes. STF contends that, historically, industry practice was to round the duration of a call to the next highest minute. For the first several years of the contract, STF rounded calls with durations of six seconds or greater, to the next highest minute. Accordingly, if the actual duration of a call was 2 minutes and 34 seconds, STF would round the call to 3 minutes for billing purposes. Beginning in April 1995, STF began rounding calls with one second or greater to the next highest minute.

STF's West Coast Operations Director told us that 5 years ago, whole minute billing was standard in the telecommunications industry and that today, tenth of a minute reporting is standard. The Director estimated that the customers who are billed on a whole minute basis pay about 7 percent more than customers who are billed on a tenth of a minute basis.

FDIC believes STF should have rounded call duration to the next highest tenth of a minute for billing purposes--6 second increments. Accordingly, the same 2 minute, 34 second call would be rounded to 2 minutes, 36 seconds and billed as a 2.6 minute call.

STF's General Counsel told us that beginning in September 1995, STF began rounding interstate and interlata calls to the next highest tenth of a minute for billing purposes. Based on our review of STF electronic billing files and invoices, it appears that STF did began rounding interstate and interlata calls on a tenth of a minute basis. However, STF continued to round intralata and local calls on a whole minute basis.

The contract is silent regarding the rounding of call duration. Based on our review of electronic billing files, it appears that STF did have the capability to bill on a tenth of a minute basis. However, STF's tariff scheduled filed with the CPUC, effective July 1994, states that calls will be rounded to the next minute thereafter, unless otherwise specified.

Finally, duration rounding is also handled differently in the industry. Based on our review of call detail reports from PacBell, AT&T and MCI, PacBell bills on a whole minute basis, while AT&T and MCI bill on a tenth of a minute basis. We could find no definitive guidance or industry standard for call duration rounding.

On November 5, 1996, STF's General Counsel told us that STF had charged FDIC on a tenth of a minute basis starting in September 1995, although the contract did not require STF to do so. The General Counsel requested that our office recalculate what STF charges would have been had STF charged FDIC on a whole minute basis for the period September 1995 through March 1996. On January 20, 1997, the General Counsel reiterated STF's position and stated that STF was entitled to a credit for the underbilling that occurred since September 1995 as a result of STF billing in tenth of a minute increments. We estimate the effect of this billing practice for the 7 months of the contract at $6,175. Further, all whole minute scenario calculations in this report were calculated using whole minute rounding for the term of the contract and reflect STF's opinion.

Depending on the scenario used, FDIC could have saved $84,106 to $92,608 had STF billed FDIC on a tenth of a minute basis.

Requirement to Match Competitor Rates

The contract required STF to adjust its rates if FDIC negotiated a new contract with a major long distance carrier. Specifically, provision 14 of the Addendum to the Service Order, requires that if FDIC negotiates a new rate with a major long distance carrier, on a national account basis, that Fairchild has to adjust its rate by an equal percentage.

FDIC signed a national telecommunications agreement with MCI, effective April 1, 1992, about a year after the STF contract was signed. At that time, Division of Liquidation (DOL) officials in Irvine should have notified STF that FDIC had negotiated a new rate with MCI and should have required STF to comply with the terms of the agreement. However, FDIC did not notify STF of the MCI contract until 3 years later. The DIRM Service Center Manager sent a letter, dated June 17, 1995, to the STF Director. The letter referenced item 14 of the Addendum, transmitted a copy of MCI's service descriptions and rates, and requested that STF contact FDIC's telephone coordinator to discuss the adjustment of STF rates. However, STF continued to charge the $.15 minute rate through March 1996.

STF contends the MCI rates presented by FDIC were incompatible with STF's rate structure and that FDIC never communicated how STF should adjust its rates to comply with the contract. The STF Director pointed out that the contract required that, if FDIC reached a new rate with a major long distance carrier, that STF had to adjust its rates by an equal percentage. In addition to STF and MCI rates being incompatible, STF did not know what the original MCI rate was, and therefore, STF could not calculate the percent change to apply in adjusting STF's rate. Accordingly, STF never adjusted the postalized rate.

Following a September 1995 meeting with FDIC officials to discuss billing issues, STF sent a letter to DIRM Washington, dated September 28, 1995. The letter reported that STF had reviewed FDIC's concerns and found that, in some cases, STF had provided pricing inconsistent with the original agreement. Specifically, STF had not properly billed local and intralata service in all cases. STF offered to settle the dispute by: (1) reducing the price for interstate and interlata calls from $.15 per minute to $.09 and $.11 per minute, respectively, and (2) providing a one-time credit of $50,000 toward future STF billing.

The STF Director told us that FDIC never responded to the settlement offer, so STF never implemented the rate change. STF's position is that the rate in the settlement offer was completely separate from the rate adjustment required by item 14 of the contract.

FDIC DIRM officials also could not tell us what original contract rate STF should have used to calculate its rate reduction. The Chief, VVNSU, reported that FDIC did not have a national contract with a long distance carrier prior to the April 1, 1992, national contract with MCI. Accordingly, DIRM officials told us they did not have a starting point from which to determine the percentage change. FDIC Irvine management initially concluded that, at a minimum STF should have implemented the $.09 and $.11 per minute rates retroactive to June 1995, when DIRM notified STF of the contract provision. Further, in his September 16, 1996, response to OIG questions, the Chief, ASB, reported that although a national contract was not in place in July 1991, "...FDIC believes that in the spirit of the Agreement, STF should have matched MCI's rates."

Both STF and FDIC officials we interviewed agree that the intent of the contract language was to allow for the adjustment of STF rates to remain competitive with major long distance carriers. Accordingly, we performed an analysis of the effects of MCI rate changes on STF's rates. For lack of a better starting point, we referred to STF's original proposal for the contract. In its November 5, 1990, proposal, STF referred to charges FDIC was then incurring under MCI's Prism Plus Plan. The proposal presented MCI's average long distance rate at $.18 per minute and claimed that STF could save FDIC almost $14,000 annually by offering a $.15 postalized per minute rate. We determined percent changes between rates offered by MCI in its Prism Plus Plan and later in MCI's April 1992 National Contract with FDIC. We applied those percent changes to STF's $.15 per minute rate to determine how STF should have adjusted its rate to comply with item 14 of the Addendum to the Service Order. The results of this analysis are presented below in Table 10. As shown, using the MCI Prism Plus Service rate as a starting point for calculating percentage rate changes would have resulted in a 50 percent decrease in STF's long distance rate.

Table 10: Comparison of MCI Rates and STF Rate Changes Required by the Contract

Contract Rate Changes	MCI Average Rate Per Minute	Percentage Change	STF Rates Required Under the Contract
MCI Prism Plus Service (September 1990)	$.1801 per minute	N/A	N/A
STF Contract Rate (April 1991)	N/A	N/A	$.15 per minute
MCI National Contract (April 1, 1992)	$.0905 per minute	-49.75%	$.0754 per minute
MCI National Contract Rate Change (August 1, 1995)	$.0805 per minute	-11.05%	$.0671 per minute

Source: STF Contract Proposal and MCI Contract Proposal.

Had STF implemented its proposed $.09/.11 per minute rate in June 1995, FDIC could have saved between $47,138 to $52,094 over the $.15 per minute rate. Had STF matched MCI rates starting in June 1995, FDIC could have saved between $66,742 and 73,809 over the $.15 per minute rate. Finally, had STF reduced its rates by an equal percentage in response to MCI rate changes, FDIC could have saved between $80,311 and 88,813 over the $.15 per minute rate.

On March 25, 1997, Irvine management clarified its position and stated that STF should have reduced its rates by an equal percentage in response to MCI rate reductions as discussed above. Accordingly, scenarios 3 and 6 in the "Analysis of Contract Charges" section of this report present contract charges using percentage rate decreases.

Flow Through Billing of PacBell Charges for Local Exchange Service

In addition to providing long distance service, STF also provided local exchange service to FDIC. Regarding local exchange service, the Service Order Agreement states that:

> "Fairchild will compute the equivalent number of trunks to provide the specified grade of service. The Customer will pay the applicable local telephone company tariff rate per trunk times the equivalent number of trunks. This number will be reviewed by Fairchild on an as required basis. In the event the applicable tariff of the local telephone company specifies a measured rate for local service, the Fairchild rate for such service shall be equivalent to the measured rate. No discount shall apply to such service."

STF's General Counsel told our office that the contract required STF to charge FDIC according to approved PacBell tariff rates, which STF did. However, STF had negotiated a lower rate with PacBell for local service. STF's position is that it was allowed to mark up PacBell bills when charging FDIC for local service to recover administrative costs.

FDIC's position is that STF should have billed FDIC for service from PacBell, without mark up, at the rate that STF had negotiated with PacBell. FDIC's basis for this interpretation lies in CPUC Decision 87-01-063, *Re Pacific Telephone and Telegraph Company*, dated January 28, 1987. This decision developed a number of restrictions to prevent Shared Tenant Service (STS) providers, such as STF, from setting themselves up as competing local telephone companies. Staff guideline number 4 states: "All charges for service from the telephone utility or from a long-distance carrier shall be directly rebilled to tenants on a flow-through or pro rata basis and shall be separately stated on the bill." The CPUC concluded that Guideline 4 was "...a reasonable way to distinguish between resellers and customers that will not place onerous or impractical restrictions on STS providers."

Further, section 21 of the Terms and Conditions part of the contract states that: "Services provided by Fairchild may be subject to tariff regulation by the Commission...In the event of any conflict between this Agreement and such tariff, the tariff shall control."

On December 16, 1996, STF's General Counsel, acknowledged that the STS Guideline prevailed over the contract. However, the General Counsel contended that CPUC guideline 3 permitted STS providers to "...charge for its management and billing services and for use of their facilities in any manner they deem appropriate including flat or measured service charges." The General Counsel concluded that the guidelines allow an STS provider such as STF to charge a reasonable mark up of its charges from the local exchange company for local exchange service to recover its billing, facilities and management services costs in providing local exchange service.

In response to STF's interpretation, on January 13, 1997, FDIC stated that STF's interpretation of the guideline was contrary to the CPUC's intent. FDIC noted that the CPUC guidelines were proposed to implement what was then a prohibition against intralata competition and to "...distinguish resellers of interlata telecommunications from customers of the regulated telephone companies." FDIC concluded that what distinguished a reseller from an STS provider was that a reseller was allowed to "mark up" its underlying carrier's charges to recover the reseller's own operating expenses, while an STS provider must "directly rebill" the carrier's charges, which "shall be separately stated on the bill."

We analyzed the CPUC guidance and agree with FDIC's conclusion. STF's interpretation of Guideline 3 renders Guideline 4 meaningless, which cannot have been the intent of the CPUC. In our opinion, it does not make sense to argue that permission to bill for services "in any manner they deem appropriate" means that STF can disguise those billings in a markup of direct provider services, when that practice is expressly prohibited by the CPUC.

This contract difference has implications for usage rate charges--local calls, as well as, non-usage rate service--trunk lines, which are discussed later in this report. With respect to local calls, we subpoenaed from PacBell, billing and customer service records for telephone service at 4 Park Plaza. These were charges that PacBell billed to STF. We compared these records to STF charges for local exchange services billed to FDIC, listed in STF electronic billing files. We identified approximately $39,665 in STF charges to FDIC for local calls and local directory assistance that were not supported by PacBell records.

Table 11 presents our understanding of FDIC and STF's interpretation of the usage related contract issues discussed above. Both STF and FDIC have reviewed this information and concur with our characterization of their respective positions.

Table 11: Comparison of FDIC and STF Interpretations of Contract Issues

Contract Issue	FDIC	STF
<u>Long Distance Calls</u> -- subject to $.15 per minute postalized rate.	The following geographic bands are considered long distance and subject to the $.15 per minute postalized rate. ● International ● Interstate -- including Alaska and Hawaii ● Intrastate/Interlata ● Intrastate/Intralata greater than 16 miles from origin.	The following geographic bands are considered long distance and subject to the $.15 per minute postalized rate. ● Interstate -- excluding Alaska and Hawaii ● Intrastate/Interlata (calls terminating outside LATA 5)
<u>Requirement to Match MCI Rate:</u> If FDIC negotiates a new rate with a major long distance carrier on a national account basis, STF agrees to adjust its long distance rate by an equal percentage (Provision #14 of the Addendum to the Contract).	FDIC notified STF of MCI contract in June 1995. STF offered to lower rates in September 1995. FDIC believes STF should have lowered its rates by an equal percentage in response to MCI rate changes retroactive to June 1995.	STF contends that STF and MCI's rate structures were incompatible and FDIC never communicated how STF should lower its rates to match the MCI rate. STF's September 1995 letter was a settlement offer unrelated to Provision 14 of the contract.
<u>Duration of calls</u>	STF should have rounded calls to the next highest tenth of a minute (e.g. Call duration of 2 minutes, 34 seconds would be rounded to 2 minutes, 36 seconds, or 2.6 seconds for charging purposes).	STF properly rounded calls to the next whole minute (e.g. Call duration of 2 minutes, 34 seconds would be rounded to 3 minutes for charging purposes).
<u>Local Exchange Carrier Charges</u> -- PacBell tariff rates -vs- PacBell/STF negotiated rates.	STF should pass-through to FDIC, without mark up, actual PacBell charges to STF for local service (0-16 miles from call origin).	From 7/91-1/95: Charges for Intrastate/Intralata and local service (0-12 miles from call origin) based on PacBell tariff rates--not actual amount PacBell charged STF. From 2/95-present: Charges for Intrastate/Intralata based on STF tariff rates. Charges for local service based on PacBell tariff rates--not actual amount PacBell charged STF.

Non-Usage Service

Non-Usage rates includes charges for items not related to actual telephone service, such as charges trunk lines, DID service, and equipment rental. Key non-usage rate contract issues in question include: (1) whether STF was allowed to mark up local exchange carrier charges before passing them on to FDIC, and (2) to what extent STF was allowed to escalate equipment charges.

Under the contract, STF leased a private branch exchange (PBX) to FDIC, also known as a switch. The PBX is the telecommunications equipment that connects customer telephones and related equipment to LEC central office lines, known as trunk lines. The PBX also directs internal calls within the customer's telephone system. For the purposes of this report, the trunk lines are the external high capacity lines that connect the PBX to the LEC's central office. The LEC owns the trunk lines and charges long distance carriers access charges for using the trunk lines. The LEC also charges carriers for other products and services like direct inward dialing (DID). DID is a service which allows outside callers to directly reach individual users within a PBX without going through a central answering location.

In FDIC's case, PacBell billed STF monthly for trunk lines, DID service and access for interstate calling service. STF's position, as discussed previously in this report, is that CPUC guidelines permit STS providers to charge for management and billing services and for use of their facilities in any manner they deem appropriate. Accordingly, STF contends it was allowed to mark up PacBell charges. However, in November 1996, the General Counsel acknowledged to FDIC Irvine officials that PacBell had reduced the number of trunks at 4 Park Plaza but STF had not reduced the corresponding charges to FDIC. The General Counsel did not know the date or monetary effect of the reduction. However, STF revised the April and May 1996 invoices to FDIC to reflect the reduced trunk line charges. As a result, STF reduced its monthly charge for trunk lines from $5,760 to $1,993.

FDIC's position is that PacBell charges to STF for service at 4 Park Plaza should have been passed through to FDIC without mark up. Based on our review of PacBell Customer Service Records to STF, PacBell initially billed STF about $4,009 a month for 240 trunk lines[3]. STF, in turn, billed FDIC for the same number of trunk lines, but charged FDIC $4,800 a month. Around April 1992, PacBell reduced the number of trunk lines to 140. PacBell further reduced the number of trunk lines to 80 in December 1992. However, STF continued to bill FDIC for 240 trunk lines at $4,800 a month. In February 1995, STF increased the monthly charge for trunk lines to $5,900 then lowered the charge to $5,760 in April 1995. Figure 2 on the following page, presents a comparison of STF and PacBell monthly charges for trunk lines at various times over the term of the contract.

We subpoenaed PacBell Customer Service Records to STF for service at 4 Park Plaza. We identified PacBell charges for trunk lines, DID service and access for interstate calling. We compared PacBell charges to STF electronic billing files to FDIC for the same charges and

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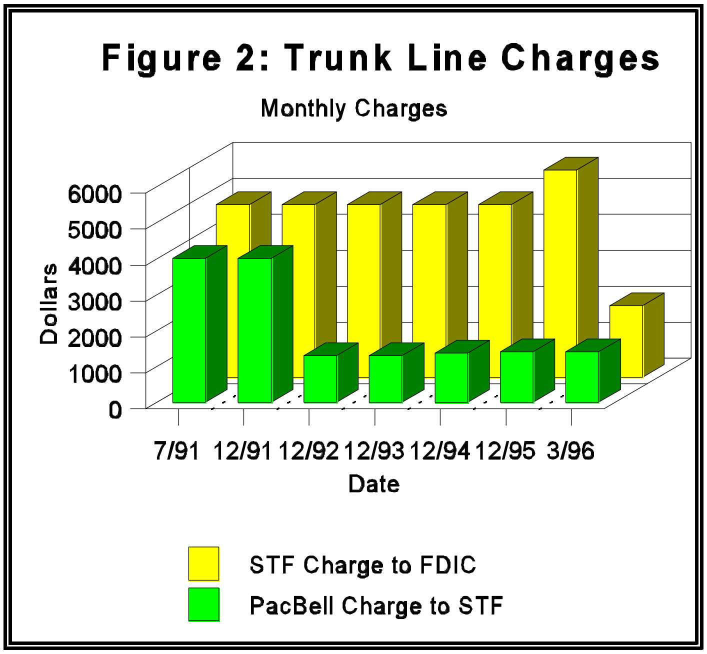
[3]PacBell basically billed STF for three products and services: trunk lines, access for interstate calling, and DID service. STF billed FDIC for trunk lines and DID service. To be conservative and to ensure that we included all PacBell costs to STF, we grouped PacBell trunk line charges and access for interstate calling charges together. Accordingly, for the purposes of this report, PacBell trunk line charges include trunk line charges and access for interstate calling charges.

identified $191,585 in pass through charges for trunk lines and DID service that were not supported by PacBell billings.

We presented our analysis of trunk line and other PacBell charges to STF on January 7, 1997. On January 20, 1997, STF's General Counsel responded that STF would accept our analysis for the time being, but reserved the right to review supporting documentation in the future.

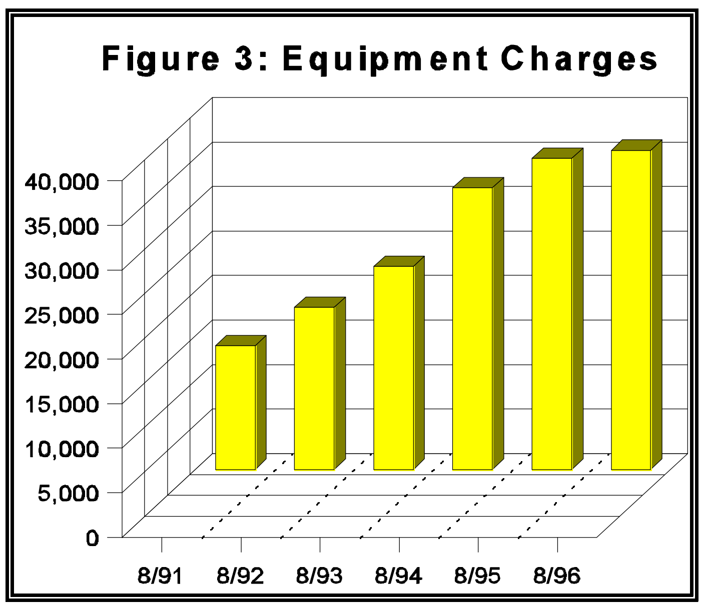


Escalation of Equipment Charges

The single largest expense category under the contract has been for telecommunications equipment. Roughly 39 percent of total STF charges is comprised of charges for telephone units, voice mail boxes, and other hardware. As of March 1996, the FDIC Irvine Office leased more than 900 telephone units from STF.

The first page of the contract consisted of a Service Order Agreement which included a schedule of 12 equipment items. The schedule itemized non-recurring and monthly recurring charges for each equipment type. The total monthly recurring charge for equipment was subject to a 63.8 percent discount. However, the Service Order Agreement did not present how the discount was applied to the individual equipment items.

Overall, we identified significant increases in equipment prices over the term of the contract. For example, in August 1991, STF charged $13,868 for equipment. By June 1995, STF was charging over $35,000 a month. Figure 3 presents the STF monthly equipment charges at various points in the contract.



The initial complement of equipment--including approximately 746 telephone units, was installed in three stages during June 1991. The most common equipment items, the DTerm 2 and the DTerm 6, had an initial discounted price of $1.00 and $4.00, respectively. However, beginning in September 1991 FDIC began moving, adding and deleting telephone units. These additional units were billed at monthly recurring prices of $25 for a DTerm 2--a 2,400 percent increase, and $29 for a DTerm 6--a 625 percent increase. Over the life of the contract, FDIC made hundreds of changes to its telephone structure. Most, if not all, additions were billed at monthly recurring rates in excess of $25. When FDIC added a new piece of equipment, STF required FDIC to sign a work order authorizing the new equipment. Table 12 presents a comparison of the prices charged for a DTerm 2 telephone over the life of the contract.

Table 12: Comparison of Equipment Prices for DTerm 2 Telephones

Equipment Type	August 1991			August 1993			August 1995		
	Monthly Charge	Units	Total Charge	Monthly Charge	Units	Total Charge	Monthly Charge	Units	Total Charge
DTerm 2	$1.00	307	$307.00	$1.11	243	$269.73	$1.17	1	$1.17
				25.00	2	50.00	1.23	152	186.96
				26.25	46	1207.50	25.00	26	650.00
				27.83	5	139.15	26.25	1	26.25
							27.56	30	826.80
							28.94	32	926.08
							29.00	1	29.00
							30.68	4	122.72
Avg. Per Unit/ Total Charge	$1.00	307	$307.00	$5.63	296	$1,666.38	$11.21	247	$2,768.98

Source: STF monthly electronic billing files.

Section 4, "Price and Payments" of the Terms and Conditions page of the contract, as amended by the Addendum to the Service Order Agreement states:

> "Customer agrees to pay for the Services at the rates specified on the first page of this Agreement or in Fairchild's standard rate card, as appropriate. Customer's non-usage based rates may be subject to an annual increase not to exceed the lesser of five percent (5%) of [sic] the Bureau of Labor Standards and Statistics CPI for Urban Wage Owners of Southern California. [sic] upon thirty (30) days written notice by Fairchild."

On December 16, 1996, STF's General Counsel reported that STF had overcharged FDIC by $63.08 associated with the initial installation of telephone equipment in June 1991. With respect to the pricing of additional equipment, the General Counsel stated STF had charged FDIC in accordance with the contract. The General Counsel reported that STF agreed to provide FDIC the telecommunications equipment listed on the first page of the Service Order Agreement at the monthly recurring charges specified. Those charges reflected the agreed upon discount from STF's standard rate card in effect at the time the parties signed the agreement.

The General Counsel acknowledged that the Agreement did not specify any pricing for equipment added after the initial complement, but stated that STF added additional equipment at the rates specified in STF's standard rate cards, pursuant to Section 4 of the Terms and Conditions page. He stated the rate cards contained the "as appropriate" rates called for in Section 4 and these rates were documented in work orders submitted to the FDIC for each move, add, or change.

The General Counsel added that the Agreement was consistent with customary industry practice in which different pricing applies to the complement of equipment that is initially ordered and equipment that is later ordered. Finally, the General Counsel added that Paragraph 2 of the Addendum to the Agreement confirmed STF's position. Paragraph 2 states:

> "Fairchild and Customer agree that in each of the third (3rd) year and fourth (4th) year of this Agreement, Customer may reduce the number of telephones contracted for by eighty (80) for a cumulative total of one hundred sixty (160) at the end of such fourth year. Upon such reduction of telephones, Customer's charges will be reduced by an amount equal to fixed monthly station charges for the number of telephones deleted. For billing purposes, the telephones removed pursuant to this section shall deemed to be from among those telephones subject to the sixty-five percent (65%) discount specified on the front page of this Agreement."

The General Counsel concluded that both STF and FDIC clearly recognized by Paragraph 2 that additional telephones might be later added to the Agreement at higher rates and therefore wished to insure any telephones deleted under this provision were removed from STF's billing at the lower discounted rates specified on the first page of the Agreement.

On September 24, 1996, FDIC's Chief, Acquisition Services Branch, reported that FDIC's interpretation of equipment pricing under the contract is that prices set forth on the first page of the Service Order Agreement would have been in effect at the inception of the contract. Further, price changes would have been evidenced by "Rate Cards" received by FDIC periodically. Also, price changes would have been subject to the limitations of Section 4 of the Terms and Conditions as amended by Sections 2 and 3 of the addendum. These sections limited non-usage rate price increases to the lesser of 5 percent or the Consumer Price Index.

FDIC could provide no evidence that it had received standard rate cards from STF prior to May 1996. STF contends that it provided FDIC with standard rate cards. However, STF could only support that rate cards were provided on three occasions, starting in October 1994. With respect to work orders, FDIC opined that work orders did not amend the agreement. Further, FDIC contended that work order prices and rate card prices should have conformed to Section 4 of the Terms and Conditions portion of the contract.

We analyzed this issue and developed our own conclusions. First, the agreement between STF and FDIC was drafted by STF. Terms are not consistently used or defined. Therefore, it is not always easy to determine the intent of the parties in executing the contract. This brings three principles of contract interpretation into play. First, ambiguities in a contract are construed against the drafter. Second and third, where the intent of the parties in contracting cannot be ascertained, standard industry practice and the course of conduct by the parties under the contract may be examined to determine that intent.

As mentioned earlier, STF asserts that the equipment charges incurred after the initial installation are not covered by the first page of the agreement, nor are they subject to the notice of increase provision. STF contends that the rates on the first page only "reflect the agreed upon discount from STF's standard rate card charges in effect at the time..." and were not intended to apply to subsequent equipment charges. STF argues that the rate card charges are appropriate for subsequent equipment charges.

STF further argues that paragraph 2 of the Addendum confirms that only the initial equipment installed would be subject to the discount. Paragraph 2 states that the FDIC may reduce the number of telephones contracted for by 80 per year in the third and fourth contract years, and that for billing purposes these phones "shall be deemed to be from among those telephones subject to the sixty-five percent (65%) discount specified on the front page of this Agreement."

However, the discount is <u>not</u> reflected in the unit charges specified on the first page of the contract, and is in fact a discount beyond the rates specified for those units. The discount is computed on a separate line, and was deducted after computation of the per unit charges. If, for example, the FDIC decided to delete 20 DTerm 2 Series II telephones, the deletion would not be at the undiscounted $4 per unit charge contained on page one of the contract, but rather at the discounted rate of $1.00.[4]

STF contends that the 5 percent limitation on rate escalation, as well as the 30 day notice provision, also do not apply to increases in charges for equipment. STF argues that "non-usage based rates" means "monthly recurring charges" and nothing else. However, that is not

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[4]According to the General Counsel, STF did not consistently apply the 65 percent discount to all equipment items. Rather, the percentage discount for specific equipment items varied. For example, the actual percent discount for a DTerm 2 was 75 percent.

the plain meaning of the term, and nowhere is it so defined. Moreover, STF wrote the agreement, which uses the term "non-usage based rates" on page two in the context of pricing escalation, and uses the term "monthly recurring charges" on page one. If STF intended "non-usage based rates" to be limited to "monthly recurring charges", it would presumably have simply used the latter term in the pricing clause.

Moreover, under the column entitled "monthly recurring charges" on page one, there is listed equipment rental charges of precisely the same equipment for which STF subsequently charged rate card rates. It would thus appear that even if the term "non-usage based rates" was the same as "monthly recurring charges", equipment rental is covered either way, and an increase of more than 5 percent per year, or any increase without notice, is impermissible. At most, even if one accepts STF's interpretation that "non-usage based rates" do not include subsequent equipment charges, that interpretation would apply to the non-recurring charge (e.g. the installation fee) associated with these tasks, not the recurring (i.e. rental) equipment fees.

In our opinion, the contract does not support STF’s position. A more reasonable interpretation of the pricing provision is that the services listed on page one will be provided at the rates thereon, and those not listed on page one will be provided at card rates. The provision also gave STF the right to increase charges up to 5 percent on an annual basis with 30 days notice by STF.

With respect to standard industry practice, FDIC has argued that within the telecommunications industry, equipment charges incurred after the initial installation are typically no higher than initial equipment charges. FDIC’s position is consistent with our interpretation set forth above.

Finally, the course of conduct of the parties is that STF charged, and FDIC paid, the higher fees. Equipment charges were part of monthly bills that were 2,000-2,500 pages long, and FDIC may not have realized that certain equipment charges contained therein were inconsistent with the terms of the contract.

Regardless of the interpretation used, we question the reasonableness of equipment escalations. As mentioned previously, hundreds of DTerm 2 telephone units were installed and billed at recurring monthly rates that were 2,400 percent higher than the agreed upon contract rates. In our opinion, such increases appear excessive.

Table 13 presents a comparison of STF and FDIC positions for non-usage items.

Table 13: Comparison of FDIC and STF Positions Regarding Non-Usage Service

Contract Issue	FDIC	STF
Trunk Line Charges, DID: Is STF allowed to mark up PacBell Trunk Line charges when passing through charges to FDIC?	STF should pass-through to FDIC, without mark up, actual PacBell charges to STF for local lines (Trunk Lines).	STF believes CPUC guidelines permitted it to charge a reasonable mark up to recover administrative costs. However, STF acknowledged that it may have overcharged FDIC by failing to adjust FDIC billings when PacBell reduced the number of trunk lines charged to STF. STF has reviewed and accepted our analysis for the time being.
Equipment Charges:	Equipment prices were set forth on the first page of the Service Order Agreement. The contract allowed for annual escalation of equipment charges by lesser of Consumer Price Index or 5 percent.	Service Order equipment prices pertain only to the initial complement of equipment. Contract is silent re: pricing of equipment added after the initial complement, but contract implies that additional equipment will be billed at higher rates. FDIC was clearly aware of this provision. Further, the contract is consistent with industry practices. Contract required written notice of price increases. This was achieved through submission of work orders which were approved by FDIC.

Source: Discussions with STF and FDIC officials.

Moves, Adds and Changes

STF also billed service charges for installing and removing equipment. STF characterized these charges as neither usage or non-usage items. These charges, known as moves, adds and changes (MAC), totaled $206,900 and accounted for about 5.6 percent of total contract costs. FDIC expressed concerns with STF MAC rates and asked our office to include MACs in our analysis. However, because FDIC did not retain work orders for the period July 1991 through January 1995 we were unable to review MAC charges. Further, because the contract is silent regarding MAC rates we could not determine the original rates that the parties intended.

However, using the contract interpretations developed in the equipment charges section of this report, the contract appears to provide that the rates on page one would be charged for services specified thereon, and rate card charges would be incurred for other services. STF's General Counsel reported that rates for MACs were specified in STF standard rate cards in effect from time to time during the term of the Agreement. According to these rate cards, STF charged between $65 to $75 for telephone installations requiring no wiring changes, $140 to $150 for telephone installations requiring wiring changes, and $8 to $15 for voice mail installations. Further, STF billed $70 per hour for labor costs. STF's tariff, effective July 11, 1994, allowed STF to bill service charges of $75 per hour. We did not attempt to determine whether STF MAC rates to FDIC were consistent with STF's tariff.

We did review several work orders that FDIC had retained. Based on our limited review, we noted several instances were STF billed a one-time charge of $24 for installing voice mail service, although STF's standard rate card listed the installation price at $15. Further, we noticed one instance where it appears that STF billed two $70 charges for moving one telephone to a new extension--$70 at both ends of the move. We could not determine how often this situation occurred or whether it was allowable. On the other hand, we noticed at least two instances where it appears that STF installed and removed large groups of phones without billing FDIC any one time installation charges. Due to the limited documentation and time constraints we did not attempt to develop these issues further.

Appendix II: Explanation of Scenarios Used to Analyze Contract Charges

Scenario 1: ***No rate change for long distance calls, whole minute rounding:***

Interstate, interlata and intralata calls billed at postalized rate of $.15 per minute from July 1991 through March 1996.

Call durations rounded to the next highest whole minute.

Scenario 2: ***STF September 1995 settlement offer implemented retroactive to June 1995, whole minute rounding:***

Interstate, interlata and intralata calls billed at postalized rate of $.15 per minute from July 1991 through May 1995.

Interstate calls billed at postalized rate of $.09 per minute from June 1995 through March 1996.

Interlata and intralata calls billed at postalized rate of $.11 per minute from June 1995 through March 1996.

Call durations rounded to the next highest whole minute.

Scenario 3: ***STF rates lowered by an equal percentage in response to MCI rate reductions, retroactive to June 1995, whole minute rounding:***

Interstate, interlata and intralata calls billed at postalized rate of $.15 per minute from July 1991 through May 1995.

Interstate, interlata and intralata calls billed at postalized rate of $.0754 per minute from June 1995 through July 1995, to reflect MCI rate change.

Interstate, interlata and intralata calls billed at postalized rate of $.0671 per minute from August 1995 through March 1996, to reflect rate change.

Call durations rounded to the next highest whole minute.

Scenarios 4,5 & 6 ***Same as scenarios 1, 2 & 3, respectively. However, call durations rounded to the next highest tenth of a minute.***

Appendix III: Methodology Used to Analyze Contract Charges

STF provided monthly electronic databases containing detailed charge amounts. Each monthly database contained roughly 60,000 records. We used a database program *Interactive Data Extraction and Analysis* (IDEA) to sort, summarize and analyze the databases. We also reconciled database amounts to STF invoices to ensure that all charges were captured. Overall, we reviewed about 2 million records and $3.7 million in contract charges during the period July 1991 through March 1996.

We determined STF and FDIC's contract interpretations and positions for how specific charges should have been characterized and billed. We developed parameters and created formulas to recalculate contract charges to reflect those positions. We then used IDEA to recalculate individual calls and other charges and developed monthly charge amounts under the scenarios and assumptions mentioned throughout this report. The following is a discussion of our methodology used to analyze selected contract issues.

Call Duration Rounding

On November 5, 1996, STF's General Counsel explained STF's interpretation for whole minute rounding. Using STF's position, we calculated charges using whole minute rounding for the entire term of the contract. For the period July 1991 through March 1995, we rounded calls with second durations of 6 seconds and greater to the next highest minute. For the period April 1995 through March 1996, we rounded calls with second durations of 1 second or greater to the next highest minute.

With respect to tenth of a minute rounding, for the period July 1991 through March 1996, we rounded each call to the next highest tenth of a minute. To convert call durations to tenth of a minute rounding, we divided one minute into ten 6 second increments (i.e, 6, 12, 18, 24...54, 60). We then rounded the call to the next highest increment. In other words, a call with a duration of 1 minute and 13 seconds, would be rounded to 1 minute and 18 seconds, or 1.3 minutes.

Contract Rates

We used several rates to determine charges under various scenarios. Table 14 presents the various rates discussed in this report using a single long distance call lasting 7 minutes and 33 seconds.

Table 14: Comparison of Rates Used in OIG Analysis

Rate Scenarios	Effective Dates	Rates	Charge Amount	
			Whole Minute	Tenth of a Minute
Contract Rate	7/91 - 3/96	$.15 Long Distance	1.20	1.14
STF 9/95 Proposed Rate	7/91-5/95	$.15 Long Distance	1.20	1.14
	6/95 - 3/96	$.09 Interstate $.11 Interlata	.72 .88	.68 .84
MCI Actual Rate	7/91-5/95	$.15 Long Distance	1.20	1.14
	6/95 - 7/95	$.0905 Long Distance	0.72	0.69
	8/95 - 3/96	$.0805 Long Distance	0.64	0.61
MCI Percentage Rate	7/91-5/95	$.15 Long Distance	1.20	1.14
	6/95 - 7/95	$.0754 Long Distance	0.60	0.57
	8/95 - 3/96	$.0671 Long Distance	0.54	0.51

Source: File documents, discussions with STF and FDIC officials.

Usage Rate Charges

We designated charges for interstate, interlata, intralata, ZUM and local calls as usage rate charges. We considered interstate calls to be all calls terminating outside of California, within the United States. We included calls to Alaska and Hawaii as interstate calls. We determined that total costs for international calls over the term of the contract were less than $2,000. Accordingly, we did not include those calls in any of our analyses.

We identified Interlata calls as those calls terminating in California, outside of LATA 5.

We designated intralata calls as including calls terminating within LATA 5 outside of a 12 mile radius of Irvine. FDIC's interpretation distinguished ZUM calls as local calls (not subject to the $.15 per minute rate). We found that STF included some ZUM calls as Intralata and some ZUM calls as local calls. We did not attempt to separately break out ZUM calls and include them exclusively as local because: (1) ZUM calls represent a small portion of total contract costs, and (2) the PacBell tariff rate for ZUM calls (13-16 miles from Irvine) and the PacBell tariff rate for Intralata calls terminating within 17-20 mile radius of Irvine were identical for the term of the contract. Accordingly, for the purposes of our analysis, intralata calls include some ZUM calls.

Local calls included calls terminating within a 12 mile radius of Irvine. In addition, local calls included some ZUM calls. We analyzed local calls as part of our analysis of PacBell pass through costs discussed below.

Non-Usage Service

Non-Usage rates included charges for trunk lines and other PacBell pass through charges and equipment. To determine the reasonableness of non-usage charges for trunk lines, DID, access charges, local calls and local directory assistance, we obtained PacBell billings to STF for those services. We compared these billings to STF billings and questioned all unsupported amounts.

Finally, with respect to equipment charges, we selected three equipment types: DTerm 2 Series II, DTerm 6 Series II, and DTerm 6 Series II with speaker. Using IDEA, we extracted all monthly equipment charges. We verified the total equipment charge from the electronic billing files to historical invoices to ensure that we captured all equipment charges. For each month, we determined what amount STF charged FDIC for this equipment and what amount STF should have charged for this equipment based on our understanding of FDIC contract interpretations.

We used IDEA to sort equipment charges first by equipment type, and second, by equipment charge. This sorting process delivered a number of summary line items as illustrated in Table 15.

Table 15: Excerpt of September 1995 STF Equipment Charges

Equipment Type	Unit Price	Units	Total Charge
DTerm 2 Series II	$1.23	152	$186.96
DTerm 2 Series II	$25.00	26	$650.00
DTerm 6 Series II	$4.90	264	$1,293.60
DTerm 6 Series II	$29.00	55	$1,595.00

Source: STF electronic billing data.

To identify the changes in equipment units each month, we determined a beginning inventory for each equipment type. We added equipment additions and subtracted deletions to arrive at an ending inventory each month.

We noticed that when an equipment item was added, STF usually charged a higher amount for the equipment in the initial month of the addition and then billed a lower recurring amount in the following months. We could not determine what the contract allowed, or what STF billed, as an initial installation charge for new equipment. To be conservative in our analysis, we did not include any charges for equipment additions in the initial month that the equipment was added. We then summarized these recurring monthly charges by equipment type.

To determine the amount that should have been charged based on our understanding of FDIC's interpretation of the contract, we developed a baseline charge amount that should have been charged for each equipment type according to FDIC's contract interpretations. We used the charge amounts from the August 1991 STF Electronic Billing Format file as the baseline. This was the second month of the contract and, therefore, represented recurring monthly charges for most equipment items. On December 16, 1996, STF confirmed that these were the appropriate rates for the initial complement of equipment.

For each month, we multiplied the recurring number of units by the baseline amounts to determine what should have been charged monthly under the contract according to FDIC's contract interpretations. We escalated the baseline charge for each equipment type by 5 percent annually as called for in the contract. Section 4 of the Terms and Conditions, as amended by Section 3 of the Addendum to the Service Order, allows an annual increase in non-usage based rates not to exceed 5 percent upon 30 days written notice by Fairchild. To be conservative, we used the highest escalation allowed in the contract from contract inception. This delivered the following baseline rates for each equipment type reviewed, as shown in Table 16.

Table 16: Baseline Equipment Charges Escalated 5 Percent Annually

Equipment Type	July 1991	July 1992	July 1993	July 1994	July 1995
DTerm 2 Series II	1.00	1.05	1.10	1.16	1.22
DTerm 6 Series II	4.00	4.20	4.41	4.63	4.86
DTerm 6 w/ Speaker	5.00	5.25	5.51	5.79	6.08

Source: OIG generated

We then compared the resulting monthly charges using STF and FDIC interpretations to determine charge amount differences.

Finally, with respect to MACs, we analyzed a limited number of work orders and compared MAC rates charged to rates in STF standard rate cards. However, because FDIC did not retain work orders for periods prior to February 1995 and because the contract did not discuss MAC rates, we could not perform a detailed review of this area.

Appendix IV: Corporation Comments